

Letter of Findings Number: 07-0603
Sales and Use Tax
For Tax Years 2004-06

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ISSUES

I. Sales and Use Tax—Imposition.

Authority: Universal Group Limited v. Indiana Dep't of State Revenue, 642 N.E.2d 553 (Ind. Tax Ct. 1994); IC § 6-2.5-1-1; IC § 6-2.5-3-2; IC § 6-2.5-4-1; IC § 6-8.1-5-1; IC § 6-8.1-5-2; [45 IAC 2.2-3-4](#); [45 IAC 2.2-4-1](#); [45 IAC 2.2-4-27](#).

Taxpayer protests the assessment of use tax on two categories included in an audit.

II. Tax Administration—Negligence Penalty.

Authority: IC § 6-8.1-10-2.1; [45 IAC 15-11-2](#).

Taxpayer protests the imposition of a ten percent negligence penalty.

STATEMENT OF FACTS

Taxpayer is a corporation operating a business in Indiana. As the result of an audit, the Indiana Department of Revenue ("Department") determined that Taxpayer owed additional sales and use tax for the tax years 2004-06. The Department issued proposed assessments for sales and use taxes, interest, and a ten percent negligence penalty. Taxpayer protests two of the categories upon which the Department imposed use tax. Taxpayer also protests the imposition of the negligence penalty. An administrative hearing was held and this Letter of Findings results. Further facts will be supplied as required.

I. Sales and Use Tax—Imposition.

DISCUSSION

Taxpayer protests the imposition of use tax on two of the categories which the Department determined were subject to use tax. The first category is royalties paid to an unrelated out-of-state corporation ("Unrelated") for the right to use Unrelated's patented "method claim" in Taxpayer's business. Black's Law Dictionary, 1161 (8th ed. 2004) defines a method claim as:

A patent claim that describes what is done to a workpiece in order to achieve the useful result claimed. A method claim is the same thing as a process claim, but "method" is used more often in applications for mechanical and electrical devices.

Taxpayer states that the royalties do not involve the purchase, rental, or leasing of tangible personal property and are therefore not subject to use tax. The second category is fees paid by Taxpayer to another unrelated party ("Purchaser") which purchased items for a business facility which Taxpayer built during the audit period. Taxpayer states that the fees do not involve the purchase, rental, or lease of tangible personal property and are therefore not subject to use tax. The Department notes that the burden of proving a proposed assessment wrong rests with the person against whom the proposed assessment is made, as provided by IC § 6-8.1-5-1(c).

The use tax is imposed under IC § 6-2.5-3-2(a), which states:

An excise tax, known as the use tax, is imposed on the storage, use, or consumption of tangible personal property in Indiana if the property was acquired in a retail transaction, regardless of the location of that transaction or of the retail merchant making that transaction.

Also of relevance is [45 IAC 2.2-3-4](#), which states:

Tangible personal property, purchased in Indiana, or elsewhere in a retail transaction, and stored, used, or otherwise consumed in Indiana is subject to Indiana use tax for such property, unless the Indiana state gross retail tax has been collected at the point of purchase.

Taxpayer's first point of protest is the payment of royalties for the use of certain method claims in Taxpayer's business. The Department imposed use tax since sales tax was not paid at the time of the payments. The Department determined that the payments were actually lease payments for the use of tangible personal property in Indiana. The Department referred to [45 IAC 2.2-4-27](#), which states in relevant part:

(a) In general, the gross receipts from renting or leasing tangible personal property are taxable. This regulation [[45 IAC 2.2](#)] only exempts from tax those transactions which would have been exempt in an equivalent sales transaction.

(b) Every person engaged in the business of the rental or leasing of tangible personal property, other than a public utility, shall be deemed to be a retail merchant in respect thereto and such rental or leasing transaction shall constitute a retail transaction subject to the state gross retail tax on the amount of the actual receipts from such rental or leasing.

(c) In general, the gross receipts from renting or leasing tangible personal property are subject to tax. The

rental or leasing of tangible personal property constitutes a retail transaction, and every lessor is a retail merchant with respect to such transactions. The lessor must collect and remit the gross retail tax or use tax on the amount of actual receipts as agent for the state of Indiana. The tax is borne by the lessee, except when the lessee is otherwise exempt from taxation.

(d) The rental or leasing of tangible personal property, by whatever means effected and irrespective of the terms employed by the parties to describe such transaction, is taxable.

(1) Amount of actual receipts. The amount of actual receipts means the gross receipts from the rental or leasing of tangible personal property without any deduction whatever for expenses or costs incidental to the conduct of the business. The gross receipts include any consideration received from the exercise of an option contained in the rental of lease agreement; royalties paid, or agreed to be paid, either on a lump sum or other production basis, for use of tangible personal property; and any receipts held by the lessor which may at the time of their receipt or some future time be applied by the lessor as rentals.

....

The Department determined that Taxpayer leased the tangible personal property and called the lease payments "royalties." The Department therefore imposed use tax on the payments, as provided by [45 IAC 2.2-4-27\(d\)\(1\)](#).

Taxpayer protests that the tangible personal property in question is leased in a separate transaction, which Taxpayer agrees is subject to sales or use tax. Taxpayer also agrees that the separate transaction in which it purchases the preprogrammed software, which runs the tangible personal property, is subject to sales or use tax. The patent holder leases the method to Taxpayer. Taxpayer states that the royalties are for the method claim which it leases every time its customers use the tangible personal property. Taxpayer states that there is no transfer of tangible personal property involved in the leasing of the method claim.

In the course of this protest, Taxpayer has submitted sufficient documentation to establish that the payments in question are for the use of the method claim, and are therefore royalty payments. Taxpayer has also established that the leasing of the patented method does not involve the leasing of tangible personal property. The leasing of the tangible personal property which enables the use of the patented method is a separate transaction. Taxpayer has met the burden imposed by [IC 6-8.1-5-1\(c\)](#) regarding its protest of imposition of use tax on the royalty payments on the patented method.

Taxpayer's second point of protest is the imposition of use tax on fees it paid to Purchaser for the purchase of furniture, fixtures, and equipment for a new structure Taxpayer built during the audit period. Taxpayer states that the fees are for Purchaser's services and that services are not subject to sales or use tax. The Department determined that Taxpayer was paying for tangible personal property along with services and referred to IC § 6-2.5-4-1, which states in relevant part:

(a) A person is a retail merchant making a retail transaction when he engages in selling at retail.

(b) A person is engaged in selling at retail when, in the ordinary course of his regularly conducted trade or business, he:

(1) acquires tangible personal property for the purpose of resale; and

(2) transfers that property to another person for consideration.

(c) For purposes of determining what constitutes selling at retail, it does not matter whether:

(1) the property is transferred in the same form as when it was acquired;

(2) the property is transferred alone or in conjunction with other property or services; or

(3) the property is transferred conditionally or otherwise.

(d) Notwithstanding subsection (b), a person is not selling at retail if he is making a wholesale sale as described in section 2 of this chapter.

(e) The gross retail income received from selling at retail is only taxable under this article to the extent that the income represents:

(1) the price of the property transferred, without the rendition of any service; and

(2) except as provided in subsection (g), any bona fide charges which are made for preparation, fabrication, alteration, modification, finishing, completion, delivery, or other service performed in respect to the property transferred before its transfer and which are separately stated on the transferor's records.

For purposes of this subsection, a transfer is considered to have occurred after delivery of the property to the purchaser.....

(Emphasis added.)

The Department also referred to [45 IAC 2.2-4-1](#), which states:

(a) Where ownership of tangible personal property is transferred for a consideration, it will be considered a transaction of a retail merchant constituting selling at retail unless the seller is not acting as a "retail merchant".

(b) All elements of consideration are included in gross retail income subject to tax. Elements of consideration include, but are not limited to:

(1) The price arrived at between purchaser and seller.

(2) Any additional bona fide charges added to or included in such price for preparation, fabrication,

alteration, modification, finishing, completion, delivery, or other services performed in respect to or labor charges for work done with respect to such property prior to transfer.

(3) No deduction from gross receipts is permitted for services performed or work done on behalf of the seller prior to transfer of such property at retail.

The Department determined that Purchaser had paid use tax on the tangible personal property but not on the fee charged to Taxpayer by Purchaser. The Department did not impose use tax on the tangible personal property upon which use tax had already been paid. The Department imposed use tax on the fees charged by Purchaser for its services, including freight, delivery, shipping, and handling charges upon which no use tax was paid.

Taxpayer protests the imposition of use tax on the fees. Taxpayer states that IC § 6-2.5-4-1(b) explains that a person is "selling at retail" when that person acquires tangible personal property for the purpose of resale and transfers that property to another person for consideration. Taxpayer believes that Purchaser did not acquire the property for the purpose of resale and therefore should not be subject to use tax on its fees. Taxpayer characterizes its relationship with Purchaser as that of an agent.

While the sales and use tax codes and regulations do not define what constitutes an agency relationship, the Indiana Tax Court has provided guidance. In *Universal Group Limited v. Indiana Dep't of State Revenue*, 642 N.E.2d 553 (Ind. Tax Ct. 1994), the court explained:

Indiana employs the Restatement definition of agency, which requires an agent to be under the control of the principal. Our courts have never wavered from this definition, in gross income tax cases or any other case. Id. at 557.

Therefore, Indiana requires an agent to be under the control of the principal in order to have a valid agency relationship. In the instant case, the documentation does not establish that Purchaser was under the control of Taxpayer. The documentation simply states that Purchaser is providing services and invoicing Taxpayer for the costs incurred along with additional fees. Under the standard explained by *Universal Group*, this is not sufficient to establish an agency relationship.

Since there is no agency in this case, the relationship is a standard seller/buyer relationship in which tangible personal property is resold by Purchaser to Taxpayer. The Department notes that IC § 6-2.5-4-1(c)(2) states that, for purposes of determining what constitutes selling at retail, it does not matter whether or not the property is transferred alone or in conjunction with other property or services. Also, the Department refers to [45 IAC 2.2-4-1\(b\)](#), which includes any additional bona fide charges added to or included in such price for preparation, fabrication, alteration, modification, finishing, completion, delivery, or other services performed in respect to or labor charges for work done with respect to such property prior to transfer when determining if tangible personal property was transferred for consideration.

The Department also refers to IC § 6-2.5-1-1(a), which states:

(a) Except as provided in subsection (b), "unitary transaction" includes all items of personal property and services which are furnished under a single order or agreement and for which a total combined charge or price is calculated.

Also, IC § 6-2.5-1-2 states:

(a) "Retail transaction" means a transaction of a retail merchant that constitutes selling at retail as described in [IC 6-2.5-4-1](#), that constitutes making a wholesale sale as described in [IC 6-2.5-4-2](#), or that is described in any other section of [IC 6-2.5-4](#).

(b) "Retail unitary transaction" means a unitary transaction that is also a retail transaction.

The documentation shows that Purchaser charged a total amount to Taxpayer. That total included costs of tangible personal property as well as Purchaser's fees. Since Purchaser acquired tangible personal property for resale and transferred that tangible personal property to Taxpayer for consideration, Purchaser was engaged in selling at retail under IC § 6-2.5-4-1. Since the amount which Purchaser charged Taxpayer included costs of tangible personal property and services, this was a retail unitary transaction, as provided by IC § 6-2.5-5-2(b). Use tax is imposed on retail transactions under IC § 6-2.5-3-2(a). Taxpayer has not met the burden imposed by IC § 6-8.1-5-1(c).

In conclusion, Taxpayer has established that the royalty payments were for a separate leasing of intangible personal property, not for a transaction which involved tangible personal property. The royalty payments are not subject to use tax. It has not been established that Purchaser was an agent of Taxpayer. The transactions between Purchaser and Taxpayer constitute selling at retail in a retail unitary transaction, and the fees and charges for services are properly subject to use tax.

FINDING

Taxpayer's protest is sustained in part and denied in part.

II. Tax Administration—Negligence Penalty.

DISCUSSION

The Department issued proposed assessments and the ten percent negligence penalty for the tax year in question. Taxpayer protests the imposition of penalty. The Department refers to IC § 6-8.1-10-2.1(a), which states in relevant part:

If a person:

....
(3) incurs, upon examination by the department, a deficiency that is due to negligence;

....
the person is subject to a penalty.

The Department refers to [45 IAC 15-11-2\(b\)](#), which states:

Negligence, on behalf of a taxpayer is defined as the failure to use such reasonable care, caution, or diligence as would be expected of an ordinary reasonable taxpayer. Negligence would result from a taxpayer's carelessness, thoughtlessness, disregard or inattention to duties placed upon the taxpayer by the Indiana Code or department regulations. Ignorance of the listed tax laws, rules and/or regulations is treated as negligence. Further, failure to read and follow instructions provided by the department is treated as negligence. Negligence shall be determined on a case by case basis according to the facts and circumstances of each taxpayer.

[45 IAC 15-11-2\(c\)](#) provides in pertinent part:

The department shall waive the negligence penalty imposed under [IC 6-8.1-10-1](#) if the taxpayer affirmatively establishes that the failure to file a return, pay the full amount of tax due, timely remit tax held in trust, or pay a deficiency was due to reasonable cause and not due to negligence. In order to establish reasonable cause, the taxpayer must demonstrate that it exercised ordinary business care and prudence in carrying out or failing to carry out a duty giving rise to the penalty imposed under this section.

In this case, Taxpayer incurred a deficiency which the Department determined was due to negligence under [45 IAC 15-11-2\(b\)](#), and so was subject to a penalty under IC § 6-8.1-10-2.1(a). While Taxpayer was partially sustained in Issue I above, Taxpayer has not affirmatively established that its failure to pay the remaining deficiency was due to reasonable cause and not due to negligence, as required by [45 IAC 15-11-2\(c\)](#).

FINDING

Taxpayer's protest is denied.

CONCLUSION

Taxpayer is partially sustained in Issue I. The royalty payments in question are not subject to use tax. Taxpayer is partially denied in Issue I. The service fees in question are subject to use tax. Taxpayer is denied in Issue II. The imposition of penalty is appropriate.

Posted: 11/26/2008 by Legislative Services Agency

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